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WHY RESTRICTIONS ON INTERNVENTIONS IN CAPITAL MARKETS SHOULD NOT BE INCLUDED IN AMERICAN FREE TRADE AGREEMENTS

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I am sorry that because of previous commitments, I cannot appear before you today. The importance of the subject of these hearings cannot be overestimated. There are implications for global economic stability and poverty reduction, and continuing progress in trade liberalization, as well as for broader relations with other countries around the world.

The provisions in the recent trade agreements with Chile and Singapore limiting government interventions in short term capital flows are a major source of concern. Everything should be done to eliminate them from the agreements, and to make sure that such provisions are not inserted into future trade agreements.

The purpose of trade agreements is to facilitate trade, and to eliminate trade barriers among countries. In principle, reducing such trade barriers can be of benefit to all parties, as each country is enabled to take greater advantage of its comparative advantage. Shifting resources from low productivity protected sectors to high productivity export sectors enhances growth and incomes.

Problems are encountered, however, when trade agreements go beyond trade issues, as in this case, forcing countries to undertake measures which should be a matter of national sovereignty. Such provisions have earned trade agreements a reputation for undermining democracy, and I believe that sometimes these accusations are deserved.

It is of salient concern when the particular provision risks imposing considerable harm on the country. Much of the instability in global financial markets in recent years, especially in emerging markets, has been related to short term capital flows. Capital rushes into a country, and just as quickly rushes out, leaving havoc in its wake. The crises in East Asia were largely caused by premature capital market liberalization. Moreover, liberalizing fully short term capital flows inhibits the ability of a country to engage in countercyclical macro-economic policies, which helps explain why so many of the countries that have liberalized capital markets have exhibited so much volatility. This volatility is particularly hard on the poor, and indeed serves to create poverty. It is the low skilled workers who bear the brunt of the recessions and depressions.

While econometric studies have confirmed that capital market liberalization is systematically related to greater risk, and an enhanced likelihood of a crisis, there is little evidence that liberalization increases growth. It is a case of risk without reward. And this is to be expected, for several reasons. First, the risk itself is bad for investment. Crises force firms, especially small enterprises, into bankruptcy and destroys entrepreneurship—always scarce in developing countries. Foreign firms too find countries with greater stability more attractive for investing. Secondly, one cannot build factories or create employment using money that can leave overnight, and it is these *real* investments which gives rise to growth. Indeed, capital inflows often lead to exchange rate appreciation, which makes it more difficult for countries to export or to compete against imports. Thirdly, in today's world, there is increasing recognition that prudential policies on the part of government require that they maintain reserves equal to the amounts that they hold in short term foreign denominated liabilities. Hence, when a firm within a poor developing country borrows short term abroad, it in effect forces the government to set aside a corresponding amount in reserves, typically held in U.S. dollar T-bills. In effect, the country is borrowing, say, $100 million from an American bank, paying say 18% interest, and at the same time lending precisely the same amount to the U.S., and receiving today less than 2% interest. The country as a whole loses on the entire transaction. The money the government put into reserves could have yielded far higher returns, say invested in education, roads, or health. It is no wonder then that so many countries have been so skeptical about capital account liberalization.

Chile, in its period of rapid economic growth, in the early 90s, imposed restrictions on the inflow of capital. I believe that such restrictions played an important role in its growth and stability. In particular, it meant that when global capital markets suddenly changed their attitudes towards emerging markets, and when capital started flowing out of them and the markets insisted on far higher interest rates, Chile was spared the pains inflicted on so many other countries (though of course it still faced problems caused by changing copper prices.) Such restrictions on capital inflows are of limited relevance in the current economic situation—with an overall dearth of capital flows to emerging markets—hopefully, at some time in the future, when capital flows are more abundant, Chile might find it in its own best interests to dampen these flows, to avoid the irrational exuberance that has afflicted so many countries. Whether Chile chooses to do so should be a matter of its own determination.

By the same token, the developing countries in Asia that have grown the fastest, done the most to eliminate poverty, and exhibited the greatest stability have all intervened actively in capital markets at critical stages in their development—and many continue to do so today. They have shown forcefully that one can attract huge amounts of foreign direct investment, without fully liberalizing markets to short term speculative flows.

Today, there is also growing recognition that in times of crises, it may be desirable to impose restrictions or taxes on capital outflows. Malaysia did so, and as a result, had a downturn that was shorter and shallower than many of its neighbors. Malaysia was able to emerge from the crisis with less of a legacy of government debt than the other countries who had not imposed such controls. Again, while economists may continue to debate about whether other countries should, in circumstances similar to those confronting Malaysia, chose to impose controls, and while they may also continue to discuss whether it is better to impose exit taxes or explicit controls, it is clear that this is a matter of such importance to each country that it should be left up to themselves to decide. Arguably, the United States pushed Korea towards premature capital market liberalization (when it was already in the process of formulating a gradual path of liberalization), and the crisis which it faced four years later was, in part, the consequence.

Let me be clear: while there are certain financial interests in the United States that might benefit from forcing countries to open up to these short term capital flows—and there are even some who have benefited from the resulting economic chaos, by buying assets at fire sale prices, only to resell them at great profits when economic calm has been restored—forcing countries to open up their markets to these short term capital flows is *not* in the interests of the United States. It is in our interests to have a more stable global economy. It is in the interests of our businesses that are investing abroad that there be greater economic stability in the countries in which they are investing. Yet economic research has identified short term capital market liberalization as the single most important factor contributing to the instability both in East Asia and Latin America.

Today, there is a growing consensus among economists *against* liberalizing capital markets for short term capital flows for most emerging countries. Even the IMF has recognized this. The extent and form of capital market liberalization is a matter which should be left for each country to decide, through democratic processes. We can encourage a full democratic debate on these issues, with a public discussion of experts from developed and developing countries debating the advantages and disadvantages, the risks and rewards, including alternative designs for interventions. But we should not be using our economic power and the promise or hope of increased investment and exports, to impose the viewpoint of particular set of interests, or particular ideology, on our trading partners. Trade should be bringing us all closer together. Trade agreements with these kinds of provisions are likely to do just the opposite. This is especially the case if the kinds of patterns we have observed in recent years continue, with the short term capital flows contributing so much to instability, and with its accompaniment of insecurity and poverty.

The arguments for trade liberalization totally distinct from those for capital market liberalization. They share in common but one world, "liberalization." There is an emerging consensus among economists that emerging markets should be particularly wary about full capital account liberalization, exposing themselves to the vicissitudes of short term speculative capital flows. It makes little sense for our trade agreements to be pushing on our trading partners restrictions which fly in the face of sound economics.

The author was formerly Chairman of the Council of Economic Advisers (1995-1997) and Chief of the World Bank (1997 He won the Nobel Prize in Economic Science in 2001